Haberlin, Sandra, Ms, OSD-ATL

From:	Hudnell Tom Civ ASC/PKFA [Tom.Hudnell@wpafb.af.mil]
Sent:	Thursday, November 15, 2001 4:28 PM
To:	'sandra.haberlin@osd.mil'
cc:	Corpus Charles W Civ ASC/PKF
Subject:	COMMENTS ON DFARS CASE 2000-D018
Follow Up Flag:	Follow up
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DRAFT WGL - COMMENTS #1.doc DRAFT WGL - COMMENTS #2.doc DRAFT WGL - COMMENTS #3.doc DRAFT WGL - COMMENTS #4.doc DRAFT WGL - COMMENTS #5.doc DRAFT WGL - COMMENTS #6.doc
PROFPOL2.PPT WGLASA.DOC

Sandra,

Attached is the information we spoke about on the phone. Six of the attachments are specific comments on the draft profit policy and two of the attachments are related to the Alternate Structured Approach (ASA) that was developed at ASC/PK. I hope these comments are helpful. My phone number is DSN 785-2552 x4203 if you would like to discuss any of the attachments.

Have a Nice Day,
TH

<<DRAFT WGL - COMMENTS #1.doc>> <<DRAFT WGL - COMMENTS #2.doc>> <<DRAFT WGL - COMMENTS #3.doc>> <<DRAFT WGL - COMMENTS #4.doc>> <<DRAFT WGL - COMMENTS #5.doc>> <<DRAFT WGL - COMMENTS #6.doc>> <<PROFPOL2.PPT>> <<WGLASA.DOC>>

Haberlin, Sandra, Ms, OSD-ATL

From: Hudnell Tom Civ ASC/PKFA [Tom.Hudnell@wpafb.af.mil]
Sent: Friday, November 16, 2001 3:51 PM
To: 'sandra.haberlin@osd.mil'
cc: Corpus Charles W Civ ASC/PKF
Subject: MORE COMMENTS ON DFARS CASE 2000-D018

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DRAFT WGL - COMMENTS #7.doc

Sandra,

Attached is one additional set of comments I just received.

Have a Nice Weekend,
TH

<<DRAFT WGL - COMMENTS #7.doc>>

The new method might be a better benchmark for profit since there is less emphasis on facilities investment. However, the new policy states "The intention of the proposed profit policy changes is to revise the incentive structure of the policy and not to increase or decrease average profit objectives." As long as we are giving contractor's 13-14% profit in a sole source environment, we will probably still be giving the contractor a higher profit than what the WGL says to give them. Therefore, we will still have to game the system in order to be able to settle a typical negotiations. The more that we have to game the system in order to settle negotiations, the less credibility the WGL method has.

If the intent of this policy is to allow for a larger (higher) range of profit, giving the contracting officer more flexibility in profit negotiations, the new policy does not provide any benefits over the old policy that I can tell.

I ran a fictitious contract through the current WGL to see what the suggested profit would be. This contract had proposed Facilities Capital Cost of Money (FCCM). I assigned all of the weightings and values to their mid range and arrived at a -13% profit objective. I then tweaked the WGL to accommodate the new de-emphasis on FCCM and the suggested assigned value for equipment (17.5% (but the WGL would only go down to 20%)). The profit objective went down to -9.5%. This does not take into account the new cost efficiency factor, however.

If a negotiator were dealing with a contractor that proposed no FCCM the WGL would probably result in a slightly higher profit range because of the new higher ranges the CO has to choose from. However, in the F-16 SPO we deal with sole source negotiations with LM Aero most of the time and they do utilize FCCM.

I feel that the end result of the new WGL approach is that the negotiator and CO will find themselves explaining away the difference between the negotiated profit and the objective profit, which is what they do now. They will have to max out the values and weightings to arrive at a reasonable profit objective. Contractors will have an incentive to shift resources from FCCM to G&A in order to help justify proposed profit. The policy states that the objective is not to increase or decrease average profit objectives. Overall, they probably haven't because in the big picture (some up and some down) it will probably be a wash.

Bottom line.. .
If all of the parties still have to manipulate the system in order to arrive at reasonable profit negotiation ranges and then justify the differences between the ranges and the WGL objectives, the new profit guidelines have not accomplished anything. If DoD hopes to incentivize contractors with the check boxes on the WGL, I'm afraid that this proposed policy will fail. Why? Because the WGL is currently seen as a necessary evil to be explained away by both parties. Only when the WGL provides the parties with realistic profit ranges will the Government be able to use it as a tool to incentivize performance in certain areas with the reward being higher profit.

Reduced emphasis on facilities investment: this is probably a good idea - it's largely being ignored on programs I'm familiar with anyway. The current method can generate wild swings in profit rates for changes to the same contract. Example: I've recently done two ECPs for the F16 program. One with a lot of procured material, which generates very little cost of money, and consequently a low profit rate; and a second one, with mostly labor content, which generated a lot of facilities cost of money, and a higher profit rate. Were we able to negotiate a lower profit rate on the one with low facilities cost of money? We sustained a slightly lower profit rate on the first one only because of the lower risk inherent to the purchased material, not because of the lower facilities investment. So why bother?

Adding G&A to the base for calculating profit objective: this is a good idea. Why it was removed in the previous WGMs is beyond me.

Increased emphasis on performance risk. Sure, why not.

Special factor for cost efficiency. This is a joke. It appears to be a wedge factor that any intelligent PCO/buyer/price analyst can use to justify whatever profit rate he needs. Some of the factors listed to be considered are questionable, too. For example, PCOs can consider a contractor's obsolete parts control program to justify higher profit. But on most of our programs, the govt is paying for obsolete parts programs in one way or another. It also says you can consider cost reductions to previous programs, There is a brief note that the PCO should be aware of such things as learning and quantity purchases (issues other than cost efficiency that may have affected the previous contracts), but that reference is rather vague.

My biggest beef with the whole WGM thing is that, at least on the programs I've been working (F16, F15, others), WGM doesn't work. For companies like Lockheed, any consideration to WGM is only given when it supports a higher profit rate - otherwise it's ignored. The narrative for the DFARS change states that the goal is not to increase or decrease the average profit rates, but to change contractor behavior needed to get that profit.The notion that tweaking a factor or two by a point or half a point either way is going to incentivize a company like Lockheed or Boeing to change their operations is ludicrous. The F16 SPO has largely given up on WGM anyway. The contractor wants his 14% on every program and change, and that's the game. There is no discussion on facilities investments, or cost efficiencies. Until we require contractors to support their proposed profit with WGM, it's a generally useless tool.

General Comment

1. --- I don't believe the background information that says "the intention of the proposed profit policy changes . . . not to increase or decrease the profit percentages". It appears to me that the entire purpose of these changes is to increase the profit to DOD contractors. The reason generally given is because "Wall Street" looks down on the defense industry as stagnant and unprofitable. The thought is that if we increase their profitability, somehow their stock prices will follow.

--- I STRONGLY DISAGREE!! I believe that stock prices are tied to earnings GROWTH. When defense budgets are constant or declining, increasing a contractors profit % will not drive up stock prices because the "industry" is not considered to be growing. Hence, none of the firms in that industry (i.e. defense contractors) will be growing. The only effect that higher profit %'s has is that we buy less "defense" with our budget. The only time that pure defense stocks (i.e. no commercial business) will be attractive to Wall Street is in times of increasing/growing Defense budgets. In addition, when you look at defense stocks with significant commercial business (i.e. Boeing), the most profitable part of their business is defense. Boeing's stock price woes since the 1997 merger with McDonnell have been totally attributed to the ups and downs (mostly downs) of their commercial-jet side of the house.

WGL Specific Comments

1. I disagree to adding G&A to the cost base for establishing objectives. This will just incentivize the contractor to continually increase these costs more than what is already occurring.

2. I don't think the "cost efficiency" factor will provide any real benefit to the USAF --- the only result will be increased profit to the contractor. The reason for is there is no established "baseline" from which to measure whether we are receiving any benefit from the contractor's cost reduction efforts. I put this in the same category as value engineering in that we couldn't quantify whether we were receiving any "value". The only time a special factor such as this might be valuable is in a multi-year contract scenario where you could document the MYP prices both "with" and "without" the cost reduction effort.

3. Does the WGL still give weight/consideration to the amount financed by the contractor? With the use of Performance -Based Payments (PBP), the contractor is essentially 100% financed by the USAF (i.e. FAR allows up to 90% of PRICE) --- a substantial reduction in risk over progress payments, Since profit is suppose to represent a measure of risk, this is an area where profit percentages should be lowered (i.e. if PBPs are used). Maybe the "amount of contractor financing" factor needs to be added back into the WGL equation.

If one of our goals is to encourage cost efficiency, why are we adding general and administrative expenses to the profit base? As a part of adding G&A to the profit base the C.O. is responsible for determining if "investments are for such things as furniture and fixtures, home or group level administrative offices, corporate aircraft and hangars, gymnasiums;" (quoting draft DFAR 215.404-71-4(d)(3)). Will DCAA now be reviewing such expenses and passing this information along to C.O.'s both when we obtain audits and when we don't request audits? Are C.O.s to acquire expertise in furniture and fixtures and track such matters? Since 11 Sep 01 corporate aircraft may be a solid business decision. Are we no longer for fitness? Please rethink this portion of G&A being part of the base amount to which profit will be applied, as it would appear that cost efficiency would better be controlled in this area, by simply not adding profit to such purchases.

Another G&A expense is attorney's fees. Both Boeing and General Dynamics have significant attorney's fees for the lengthy A-12 termination that is still on going and started well over eight years ago. Vice President Cheney terminated the A-l 2 for default. The trial court revised this default termination to a termination for convenience. The appeals court remanded the decision back to the trial court. The trial court then determined that this was indeed a termination for default. Now, the matter is being appealed. Along the way the Supreme Court turned down accepting the appeal prior to the appeal at the Court of Appeals. So even if we win, i.e., the government's default termination is found on the second appeal to be correct, the government under this new profit policy would be paying profit on all or some of these contractors legal expenses. Weren't appropriate G&A expenses better controlled by just not allowing profit for such expenses? What is the rationale for paying profit on legal expenses, especially if the goal is cost efficiency?

There may be a defense contractor that should be rewarded for facilities investment. Is there any possibility that we, the government, will be permitted to consider the individual circumstances of the contractor that we are buying from? If not the C.O., perhaps there is someone in the government above the Contracting Officer who would be considered to have the requisite sound business judgment. It would appear that the government may wish to reward the activity of a prime contractor, subcontractor, or vendor for building a facility or buying equipment to produce unique military equipment, as opposed to rewarding the activity of litigating for years. According to a Newsweek article, the war fighter's helmet now "...comes complete with built-in video camera, night-vision goggles and a microphone for voice communications. The helmet is also linked to a Global Positioning satellite which displays the soldier's location, as well as the whereabouts of other American troops and suspected enemy positions." (Newsweek, "Lock and Download", 22 Oct 01). No doubt at this time, it is in our best interest for this helmet to remain a strictly military item. And it would be great to be able to incentivize the contractor with profit for increasing the production of these helmets. The new profit policy once again would appear to be an obstacle with its reduced emphasis on facilities investment, for what would appear today to be a sound business practice.

It is troubling that the C.O. "need not explain assignment of the normal value, except for the cost efficiency special factor", as the C.O. may well be pressed to negotiate without knowing enough about the contractor to assign either a higher or lower value.

It is also unrealistic to believe that a contractor that provides poor quality, untimely proposals and does not cooperate in the evaluation and negotiation of the proposal will accept a lower profit (draft DFAR 215.404-71-2 (3)). Frequently in such instances the contractor has the government team down to the wire as to when the funds will expire and the user need date, but the contractor continues to hold out for a higher profit. The government is not in a position to go to the mat over every unfair situation.

It would be excellent if the government could step back from its structured approach to profit and could pay a profit rate that is commensurate with the commercial profit rate, if not higher, for critical military items. Please consider such guidance.

Recommendation: Because of the current wartime conditions, recommend that Contracting Officers be permitted to determine profit using sound business judgment. At a later date the auditors and IG's can pull together mistakes made and good decisions made based on sound business judgment. At that point, profit guidance can be determined.

The most appreciated guidance would be a web site that has current profit and non-profit incentivizing techniques used by both the government and industry.

This new draft profit policy has one major concern that must be addressed prior to it being released in final form. The new area entitled “Cost Efficiency” has the potential to become a roadblock during the negotiation process, This is because the contractor has little responsibility to support any consideration in the range of 0 – 4%. Draft DFAR 215.404-71-5(a) states “To the extent that the contractor can “demonstrate” cost reduction efforts that benefit the pending contract, the contracting officer may increase the pre-negotiation profit objective by an amount not to exceed 4 percent of total objective cost to recognize these efforts.” This language must be made stronger to require the contractor to submit supporting rationale and documentation that can be verified through fact-finding and audit by DCAA in order to avoid subjective judgements being made that will impact significant profit dollars. We do not want the bulk of the responsibility to fall on the shoulders of the Contracting Officer to make a final determination of what to allow in this area without the proper information to consider. This may lead to extreme pressure being brought to bear on this person from both contractor and government personnel. Without this requirement of contractor responsibility, this area could simply serve to “raise the bar” of profitability with little to show for it. This is not fair to the Contracting Officer or the taxpayer. Supporting documentation and rationale from the contractor and, in turn, analysis by government personnel will serve as a check and balance of this important addition to the Weighted Guidelines. Adding this requirement will allow for a more structured approach when determining what value, if any, to allow for Cost Efficiency.

Another change that may be warranted in the Cost Efficiency area is to increase the range to allow for a negative weighting that can be applied when contractors have a history of “cost inefficiency” that has been a detriment to the viability of the program. It seems that allowing the Contracting Officer the latitude to withhold profit for inefficiency is just as reasonable as allowing the latitude to give extra profit for efficiency.

Since the Weighted Guidelines is now being adjusted, it may be time to eliminate the Cost of Money allowance. This has been a controversial element ever since it was introduced in the mid 1980s. Congress has always treated it as additional profit as indicated by the Mark-up calculation on the Weighted Guidelines. However, in truth it is a cost element subject to final pricing if the contract type is FPIF. This is further shown by the allowance of ceiling dollars for Cost of Money. There is a significant amount of effort that goes into developing the Cost of Money factors that are used by the contractor and government when calculating their respective positions. In many instances the amount of money at stake is minimal compared to the costs being negotiated. Eliminating this element at this time would in turn simplify the Weighted Guidelines and allow further increases in the Performance Risk factors for technical and cost/management.

Hopefully, the above suggestions will help formulate a dynamic profit policy that will contribute toward encouraging outstanding performance from defense contractors and subcontractors, Overall, it appears the new policy added emphasis to performance risk and added a cost efficiency factor. They lowered the emphasis on contract type risk (I was unclear what they did with working capital investment) and facilities investment.

I do not agree with the added emphasis to performance risk. I think it is already too high. I think they should have significantly added emphasis to contract type risk and to working capital investment. I do agree with lowering the weights to facilities investment, which is long overdue.

Contract Type Risk (and Working Capital):
Emphasis should be added to contract type risk. Currently, the normal weight for FFP with progress payments is 3%, versus 0.5% for CPFF. An extra 2.5% is not an adequate reward for a contractor taking all the cost risk on a program. I think the difference should be at least 5% versus 2.5%. Many times it is already hard to negotiate a FFP type contract, even when appropriate, with that small difference. And the new policy proposes to decrease the weights by one-half percent. Wrong direction; the weights for fixed price type contracts should be increased significantly. The weights for the cost-type contracts should not change. Also, I think Working Capital should be changed to further incentivize contractors to propose fixed price type contracts and to self-finance programs. This may, to some extent, get the Government out of the financing business.

Performance Risk:
I disagree with adding emphasis to performance risk. If the contractor is taking on a technically challenging program, but the contract type is cost-type, as it normally is, the Government has the risk, not the contractor. It appears on a technology incentive CPFF program, the normal WGL fixed fee would be well over 10%, maybe over 15%, and the Government would have all the risk. This is not a good deal for the taxpayers.

Efficiency Factor:
I disagree with the cost efficiency factor, especially to 4%. (1-2% may be OK.) 'We may as well go-ahead and add 4% to the WGL automatically. This factor will be based more on contractor opinions/claims/marketing, and less on substance. Cost efficiency is very hard to prove or disprove. When one PCO gives 4%, all other PCO' s will hear of it. Also, I have application questions. For example, for Lockheed, with dozens of plants around the world, does it apply to the plant doing the work, or the overall corporation?

Facilities Capital Investment (and Performance Risk):
Finally, the de-emphasis of capital investment is long overdue. The plan is to gradually decrease it to zero. I also agree with that concept. In the future, as we further decrease the weights of capital investment toward zero, we gradually increase the performance risk weights (especially technology incentive) to offset the decrease. My rationale is the technology market is down at this time; we do not need to incentivize contractors to take on high technology work and hire highly trained engineers. Highly trained personal, while were hard to find a few years ago, are much more readily available now. As this situation changes, and the technology business gets better, more demand on engineers, then increase the technology incentive, and at the same time, decrease the facility investment weights.